Internal Revenue Servic

memorandum

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to: Charles Chiapperino
International Examiner

from: Chief, Branch 2
Office of Associate Chief Counsel (International) CC:INTL:Br2

subject: Creditability of the Philippine Carriers Tax

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You have requested informal assistance in connection with the audit of [redacted] ("[redacted]") for its short taxable year ended [redacted]. At issue is whether the Philippine carriers tax imposed on international shippers doing business in the Philippines is a creditable tax within the meaning of sections 901 and 903 of the Internal Revenue Code ("IRC").[1]/ We conclude that it is not.

FACTS

During its short taxable year ended [redacted], [redacted] engaged in business in the Philippines and earned a portion of its income there under Philippine law. [redacted] filed Philippines income tax and percentage tax returns and paid an income tax and a Philippine carriers tax. [redacted] claimed both the income tax and the carriers tax as foreign tax credits on its U.S. Corporate income tax return pursuant to sections 901 and 903.

LAW

1. Philippine Law.

Foreign corporations engaged in business in the Philippines generally are subject to a tax equal to 35 percent of the taxable income derived in the preceding taxable year from all sources within the Philippines. Title II, Chapter

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1 All Internal Revenue Code references are to the Internal Revenue Code of 1954, as in effect during [redacted].

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III, Section 25(a)(1) of the National Internal Revenue Code of the Philippines ("NIRC").[2] Certain foreign corporations, shipping companies among them, are exempt from the net basis income tax and instead are taxed based on a percentage of gross receipts. International carriers doing business in the Philippines pay a tax equal to 2.5 percent of their "Gross Philippine Billings" for the year. NIRC section 25(a)(2). For international shipping companies, "Gross Philippine Billings" is defined as "gross revenue whether for passenger, cargo or mail originating from the Philippines up to final destination, regardless of the place of sale or payments of the passage or freight documents." NIRC section 25(a)(2)(B). Gross revenue is not defined.

In addition to the income tax, international shipping companies doing business in the Philippines are subject to the carriers tax. Title V, Chapter II, section 173 of the NIRC provides in part:

> SEC. 173. Percentage tax on carriers and keepers of garages.--Keepers of garages, cars for rent or hire driven by the lessee, transportation contractors, persons who transport passenger or freight for hire, and common carriers by land, air or water, except owners of bancas and owners of animal-drawn two wheeled vehicles, shall pay a tax equivalent to three (3%) per centum of their quarterly gross receipts. * * *

Gross receipts is not defined.

2. United States law - Foreign Tax Credits.

Subject to the limitations imposed by IRC section 904, section 901 allows a U.S. taxpayer a credit for the amount of income, war profits and excess profits tax (referred to collectively as "income tax") paid to a foreign country. Section 903 expands the range of creditable taxes by allowing a credit for certain taxes imposed "in lieu of" an income tax.

A taxpayer that pays a foreign levy must satisfy three requirements to qualify for the IRC section 901 credit. First, the levy must be a creditable tax. Second, the taxpayer must pay or accrue the tax. Third, the taxpayer must show that it actually paid the tax. Only the first requirement is at issue in this case.

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[2] All references to the Philippines National Internal Revenue Code are to the National Internal Revenue Code of 1977 as in effect in [redacted].

Creditability is determined independently for each separate foreign levy. Section 1.901-2(d) of the Income Tax Regulations (the "regulations") provides general principles in deciding whether a levy is a separate levy. A levy imposed by one taxing authority (e.g., the national government) is always separate from one imposed by another taxing authority (e.g., a provincial government). In addition, foreign levies are separate if each is imposed on a different tax base. A levy is not separate merely because it is imposed only on some taxpayers (e.g., corporations), nor is a levy separate because different rates apply to different classes of taxpayers. The fact that the foreign country views two levies as separate is not determinative for U.S. tax purposes.

A separate foreign levy will be creditable under section 901 if it is a tax and its predominant character is that of an income tax in the United States sense. A tax is an income tax in the United States sense if it is imposed on realized net income. If a tax is not imposed on realized net income, it may nonetheless be creditable as an "in lieu of" tax under section 903 if it is a tax and is imposed in substitution for rather than in addition to the generally imposed income tax. All of the taxpayer's income, however, need not be exempt from the generally imposed income tax. For purposes of determining creditability under section 903, it is immaterial whether the base of the foreign tax bears any relation to realized net income. Thus, the base of the tax may be gross income, gross receipts or sales, or the number of units produced or exported. Section 1.903-1(a) of the regulations.

3. U.S. - Philippines Income Tax Treaty.

The Income Tax Convention (the "Treaty") between the United States and the Philippines was signed in 1976 and approved by the Senate on December 16, 1981, on the condition that shipping and air transport income be exempt from the Philippines branch profits tax. Article 1, Taxes Covered, provides that the Philippines taxes covered by the Treaty are the income tax imposed under Title II of the NIRC, and similar taxes imposed in addition to or in place of existing taxes after the date of signature of the Treaty. The carriers tax was amended after 1976 but we have been unable to determine whether and in what form it existed at the time the Treaty was signed. Based on Article 9 (discussed below), however, the Treaty probably was not intended to cover the carriers tax.[3]

Article 9 of the Treaty, Shipping and Air Transport, provides that both the U.S. and the Philippines may tax profits from shipping earned by U.S. companies operating in the Philippines but that the Philippine tax may not exceed 1.5% of gross revenues. Article 4, par. (7) provides that gross revenues from the operation of ships in international traffic shall be treated as from sources within a contracting state to the extent they are derived from outgoing traffic originating in that state. The Senate committee report indicates that the intent of Article 9 is to lower the 2.5% tax rate imposed by NIRC section 25(a)(2). Article 9 does not mention the carriers tax, which also is imposed based on a percentage of gross revenues.

ANALYSIS

International shipping companies are not subject to the general Philippines net basis income tax. Instead they are subject to a tax equal to 2.5% of gross Philippine billings from outbound traffic. NIRC section 25(a)(2). The gross basis tax is a tax and is imposed in substitution for, and not in addition to, the general income tax. Consequently, the 2.5% tax based on gross Philippine billing, absent the Treaty, would be a creditable "in lieu of" tax within the meaning of IRC section 903.

The U.S. - Philippines tax treaty, Article 9, provides that both the U.S. and the Philippines may tax income earned by U.S. companies from shipping operations in the Philippines but

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[3] There is no mention of the carriers tax in the United States - Philippines Treaty. Article 2 of the Treaty provides that the Treaty covers only taxes imposed by Article II of the National Internal Revenue Code of the Phi[redacted] the income tax but not the carriers tax. (b)(5)(DP) [redacted].

the Philippines tax may not exceed 1.5% of gross revenues. The Treaty thus reduces the 2.5% tax imposed by NIRC section 25(a)(2) on gross revenues from outbound shipping operations to 1.5%. [redacted] paid the 1.5% treaty-rate tax and claimed a foreign tax credit for it.

International shipping companies doing business in the Philippines also are subject to the carriers tax pursuant to NIRC section 173. That tax is imposed at a rate of 3% of quarterly gross receipts. It is not intended to reach net income and thus is not a creditable income tax within the meaning of section 901. The carriers tax is imposed on a broad class of taxpayers, both domestic and foreign, including garage operators, cab drivers, and other businesses providing transportation services, Many of the taxpayers subject to the carriers tax also are subject to the generally imposed net basis income tax.

[redacted] argues that the 2.5% income tax based on gross Philippine billing and the 3% carriers tax based on quarterly gross receipts constitute a single levy for purposes of section 1.901-2(d) of the regulations because they are imposed on the same tax base. [redacted] argues that both taxes should be tested together to determine creditability and that the two taxes together constitute a foreign levy imposed in lieu of the Philippines corporate income tax.

In support of its position, [redacted] first cites section 1.903-1(b)(3), Example (4) of the regulations. That example provides:

> Example (4). Country X has a tax that is generally imposed on the realized net income of nonresident corporations that is attributable to a trade or business carried on in country X. The tax applies to all nonresident corporations that engage in business in country X except for such corporations that engage in contracting activities, each of which is instead subject to two different taxes. The taxes applicable to nonresident corporations that engage in contracting activities satisfy the substitution requirement set forth in paragraph (b).

The example demonstrates that two levies imposed by a foreign government may be viewed as a single levy and that a tax imposed on certain taxpayers in substitution for a generally imposed income tax may be a creditable tax. The example, however, simply assumes an issue that we must resolve, that is whether the two Philippine taxes for which [redacted] was liable are imposed on the same tax base.

The Philippines imposes an income tax on international shippers under NIRC section 25(a)(2) based on "Gross Philippines Billing", which is defined as "gross revenue whether for passenger, cargo or mail originating from the Philippines up to final destination, regardless of the place of sale or payments of the passage or freight documents." (Emphasis added). "Gross quarterly receipts", the base on which NIRC section 173 imposes a tax on nonresident shipping companies, is not defined. [redacted] argues, however, that gross receipts and gross revenue are synonymous. [redacted] submits a summary of its taxes paid to the Philippines, showing that both taxes were computed using the same tax base of [redacted] pesos (see attached).

Regardless of whether the carriers tax and the income tax when applied to international shippers are imposed on the same base (gross receipts from outbound traffic), the carriers tax is imposed on a significantly larger class of taxpayers than the NIRC section 25(a)(2) gross basis income tax which applies only to international shippers. Creditability is tested based on the entire class of taxpayers subject to the foreign tax. Section 1.901-2(a) of the regulations. A tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax. Section 1.903-1(a). Many of the taxpayers that are subject to the carriers tax also are subject to a net basis income tax. Consequently, the carriers tax is imposed in addition to and not "in lieu of" a generally imposed net basis income tax and is not a creditable "in lieu of" tax within the meaning of IRC section 903.

Prior cases and rulings interpreting Philippine law also have concluded that the carriers tax is not a creditable tax. At the time these decisions were reached, Philippine law differed from the law we must now analyze and the current U.S. - Philippines Treaty had not been signed. The prior Philippine law imposed a carriers tax that was essentially the same as the current tax. The income tax imposed on international shippers, however, was a net basis income tax.

In United States v. Waterman Steamship Corporation, 330 F.2d 128 (5th Cir.), aff'd on other issues 381 U.S. 252 (1965), the Fifth Circuit held that the carriers tax paid in the Philippines by an international shipper was not a creditable tax. The Fifth Circuit interpreted Philippine law as in effect in 1949 and 1950. The carriers tax imposed at that time was essentially the same as under current law. The income tax imposed on international shippers in 1949 and 1950 was an income tax in the U.S. sense, i.e., a net basis tax. The court concluded that the carriers tax was not a creditable in lieu of tax because it was imposed in addition to, rather than in substitution for, a generally imposed income tax.

In Rev. Rul. 57-62, 1957-1 C.B. 241, we concluded that the Philippines privilege tax based on gross receipts and imposed as a condition of doing business (the carriers tax is a privilege tax) was not creditable because it was imposed in addition to the income tax. As in Waterman, the income tax imposed on international shippers at that time was a net basis income tax.

In Bank of America National Trust & Savings Association v. Commissioner, 459 F.2d 513 (Ct. Cl.), cert. denied 409 U.S. 949 (1972), the Court of Claims held that a Philippine tax of 5 percent of the gross receipts of local branches of foreign banks was not creditable because the taxpayer did not establish that the tax was essentially a tax on net income. The Tax Court reached the same result for later taxable years of the same taxpayer in Bank of America National Trust & Savings Association v. Commissioner, 61 T.C. 752 (1974). Neither court reached the issue whether the 5 percent levy was a tax in lieu of an income tax because the levy was imposed in addition to rather than in substitution for a generally imposed net basis income tax.

The income tax imposed on international shippers is now a gross basis rather than a net basis income tax. The above cases remain relevant, however, because they conclude that if a tax is imposed on net income, another tax imposed on gross income that is imposed in addition to, and not in substitution for, the net basis income tax cannot be a creditable "in lieu of" tax. The current carriers tax applies to a class of taxpayers (mainly domestic taxpayers) that also is subject to the net basis income tax. Thus, the carriers tax is imposed in addition to, and not in substitution for, the net basis income tax even though all persons subject to the gross basis carriers tax are not also subject to the net basis tax. Because the carriers tax is not imposed in substitution for the income tax, we need not decide whether the income tax and the carriers tax constitute a single levy or separate levies that are both "in lieu of" taxes.

CONCLUSION

Section 25(a)(2) of the NIRC of the Philippines imposes a gross basis tax on outbound traffic of international shippers. The tax is imposed in lieu of the generally imposed net basis income tax and subject to the Treaty rate reduction, is a creditable "in lieu of" tax pursuant to IRC section 903. Section 173 of the NIRC imposes a carriers tax on gross receipts from outbound traffic of international shippers as well as on gross receipts from numerous purely domestic transportation businesses. Most if not all of the domestic transportation businesses subject to the carriers tax also are subject to a net basis income tax. The carriers tax, therefore is a tax imposed in addition to, and not in substitution for, the generally imposed net basis income tax and is not a creditable "in lieu of" tax under IRC section 903. [redacted] may claim a credit under section 903 for the section 25(a)(2) gross basis income tax imposed at the treaty rate of 1.5 percent, but may not claim a credit for the 3 percent carriers tax.

If you have any additional questions, please contact Caren Shein on (202) 566-3452.

Sincerely yours,

Phyllis E. Marcus

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